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## Analyst's Notebook

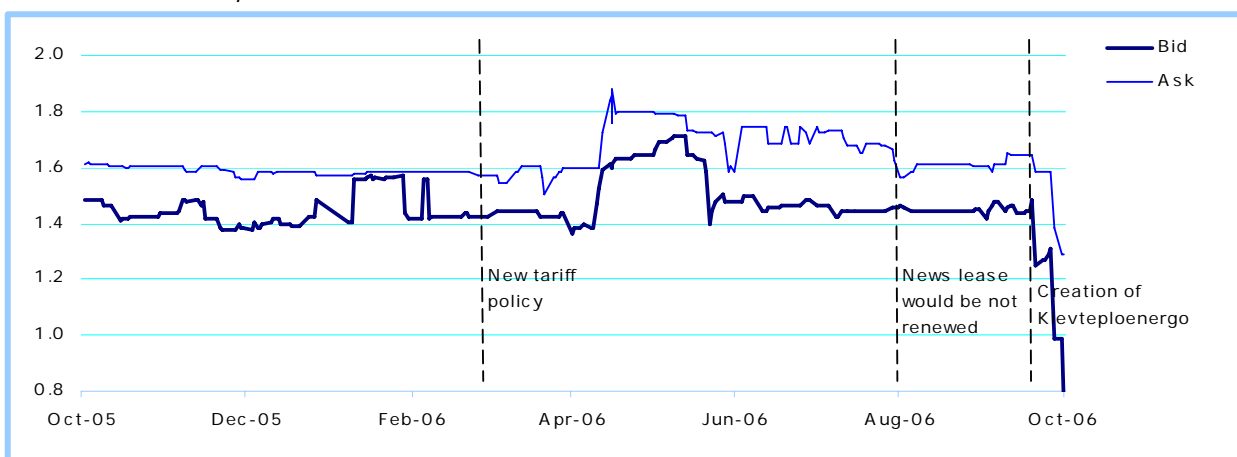
Ukraine / Electricity  
 October 6, 2006

### ***Kievenoergo: Risks Overestimated*** **KIEN upgraded to BUY as the market overreacts**

Target Price: **USD 1.74**  
 Upside: **74%**  
 Recommendation: **BUY**

Kievenoergo (KIEN) stock has lost almost 50% in bid price and 21% in ask price since Kiev's city council announced the creation of Kievteploenergo to lease and operate the city's heating infrastructure (two power plants, boilers and heat networks). That would mean that the council would not renew its lease agreement with KIEN, which is currently leasing the assets.

#### KIEN's Stock Rates, USD



Source: PFTS

We doubt KIEN will lose control of the assets, as there are many obstacles that would have to be overcome before KIEN could be deprived of the lease. The most important are political: (1) expected opposition from energy sector regulators, (2) opposition from KIEN's main creditor, the World Bank, and (3) a possible conflict between potential KIEN successors.

At any rate, we believe the stock has bottomed out at its current price and, the market's reaction to the recent announcements, represents a good opportunity to buy.

### ***What Can Stop the City's Plan?***

#### ***(1) Opposition from Sector Regulators***

The National Energy Company (NC ECU), which holds 50% of KIEN, is not interested in decreasing the company's value, which is what would happen if KIEN lost control of Kiev's power generating assets. The people in control of the NC ECU, Fuel and Energy Ministry and the National Electricity Regulation Commission (NERC) all have common origins - Donetsk business groups - and are likely to oppose Kiev's decision as a group.

KIEN is currently constructing a new power generation unit at one of Kiev's heating and power plants (CHPPs), CHPP-6. In August 2006, the Fuel and Energy Ministry decided to help the company with financing for the first time since the project began by allowing a special surcharge to the electricity tariff produced at Kiev's CHPPs. The surcharge is subject to approval by the NERC.

Any increase in Kiev's CHPP electricity tariffs due to the additional surcharge for reconstruction would barely be reflected in KIEN's retail electricity tariff, because the increase would be covered by all of Ukraine's energy consumers. However, if CHPP-6 is not operated by KIEN, energy sector regulators would be unlikely to help with financing via an additional surcharge. In that case, Kiev would have to raise the needed money for reconstruction through corresponding increases in household heating tariffs, which would not be popular. Therefore, Kiev will have to either accept the *status-quo* or freeze construction of the new power unit.

### ***(2) World Bank is Likely to Oppose***

The World Bank, which started a program to renovate Kiev's heating infrastructure in 1998 and loaned about USD 200 mln for the project, is also very likely to oppose changing the operator of these assets while the project is underway. The World Bank is an influential player, with access to the president and government if problems with local authorities negatively affect its projects.

### ***(3) Possible Conflict between Potential KIEN Successors***

The creation of Kievteploenergo by the Kiev City Council is a sign of conflict between two influential forces: the Kiev Mayor's office and a group around Vasily Khmelnytsky, KIEN's largest private shareholder. Before Kievteploenergo was created, the most likely candidate to become the new lessee of Kiev's heating infrastructure was Kievenergoholding, a company jointly controlled and owned by Khmelnytsky's group and the city of Kiev. Now, the Kiev mayor has an alternative, Kievteploenergo, which is fully owned by the city and thus of no benefit to Khmelnytsky. We expect KIEN management and its main shareholder, the NC ECU, to take advantage of this conflict to continue KIEN's lease.

### ***KIEN's Future: Much Will Depend on the EGM***

The NC ECU reacted strongly to Kiev's announcement that it would not renew its lease with KIEN, and the NC ECU's recent moves show it is increasingly aware of the troubles surrounding the Ukrainian capital's heat and energy supplier. A month after the news, an EGM (to be held on Oct. 10) was called to replace KIEN's top management. Two weeks after that, Yuriy Prodan was appointed deputy General Director of KIEN. He is a strong crisis manager who will attempt to counteract the potentially destructive activity of Kiev's City Administration.

#### ***Profile: Mr. Prodan***

Yuriy Prodan has extensive experience in the Ukrainian energy sector, and connections to power regulators and the Kiev City Administration (he has served as head of the NERC, president of the NC ECU, director of Energorynok and head of the Kiev City Administration's energy department). Therefore, he looks like a figure able to help KIEN, the NC ECU and city authorities reach an agreement to prolong KIEN's lease of the power plants.

KIEN's EGM will show whether the NC ECU and Kiev City Administration can reach an agreement on KIEN's future. By creating Kievteploenergo on the eve of the EGM, it looks like the city is flexing its muscles. However, if Prodan is elected by the EGM as CEO of KIEN, and his candidacy is supported by both the NC ECU and the city, that would be a sign that KIEN is likely to prolong its lease.

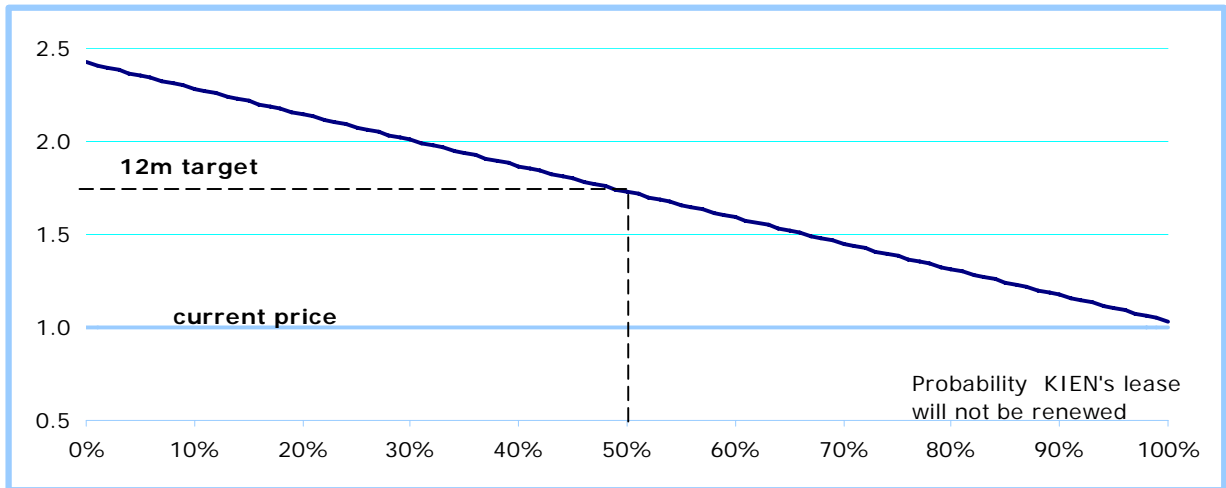
### ***Our Recommendation: BUY KIEN***

Applying a sum-of-the-parts valuation (see page 4) based on the price/electricity ratios of local peers, we value the current generation business of KIEN at USD 192.1 mln and the distribution business at USD 150.5 mln. All of KIEN's debt (USD 79 mln) is related to renovation of the heating infrastructure so we assume that if KIEN's lease is not prolonged, the debt will be inherited by the next lessee of the heating infrastructure.

We plotted implied price of KIEN (see page 3) given the probability the lease will not be renewed. The current price of KIEN implies that the market applies a 100% probability that KIEN will lose its lease of the power plants, which we believe is too conservative. We believe the probability that KIEN will continue operating the CHPPs is not less than 50%, which implies a weighted target price of USD 1.73.

While we are not changing our target price, we do upgrade our recommendation on KIEN to BUY. Keep in mind that this investment requires above average degree of risk tolerance.

**Implied KIEN Price (USD) and Probability the Lease Will Not be Renewed**



Source: Company data, Concorde Capital estimates

## Sum-Of-The-Parts Valuation

### Generation Segment

		Market Price USD	MCap USD mln	EV USD mln	El. Prod. 06E, TWh	EV/El. Prod USD/MWh
Centrenergo	CEEN	0.98	362.0	475.2	13.4	35.5
Dniproenergo	DNEN	83	325.4	402.7	13.9	29.0
Donbassenergo	DOEN	7.2	170.2	255.2	7.5	34.0
Zakhidenergo	ZAEN	32.0	409.3	467.7	15.8	29.6
<b>Mean</b>						<b>32.0</b>

#### KIEN:

El. Prod., 06E	6.0 TWh
Implied EV	192.1 USD mln
Net Debt	79.0 USD mln

Source: Company data, Concorde Capital

### Distribution Segment

		Market Price USD	MCap USD mln	EV USD mln	El. Suppl. 06E TWh	EV/El. Supply USD/MWh
DniproOblenergo	DNON	51.5	308.5	298.5	26.37	11.3
KharkivOblenergo	HAON	0.42	106.7	101.7	4.98	20.4
Krymenergo	KREN	0.43	75.2	74.21	4.09	18.2
Sevastopolenergo	SMEN	1.27	34.2	37.0	0.86	42.8
ZaporizhiaOblenergo	ZAON	1.04	186.5	185.3	10.22	18.1
ZhytomirOblenergo	ZHEN	0.79	96.9	99.7	1.86	53.5
<b>Mean</b>						<b>27.4</b>
<b>Median</b>						<b>19.3</b>

#### KIEN:

El. Supply, 06E	7.8 TWh
Implied EV (@ peer median)	150.5 USD mln

Source: Company data, Concorde Capital

**Total EV: USD 342.6 mln**

**Total MCap: USD 263.6 mln**

**Generation MCap : USD 113.1 mln**

**Distribution MCap: USD 150.5 mln**

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